BRIEF IN SUPPORT OF PETITION.

Opinion Below.

The decision of the Circuit Court of Appeals is reported in 119 Fed. (2d) 869. The decision of the Board of Tax Appeals so affirmed and reversed by the Circuit Court, is in the form of a memorandum opinion and is not officially reported. It is set forth in full in the transcript of record filed with the Circuit Court at pages 35 to 58 inclusive.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered on May 26, 1941. The jurisdiction of this court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

Statement of the Case, Questions Presented, Statutes Involved, Etc.

The statement of the case, the questions presented, Specification of Errors to be urged have been set forth in the petition. The statutes involved are set forth in the Appendix (*infra*, p. 27).

Summary of Argument.

The decisions against the petitioners involving 1932 worthlessness did not meet the ends of justice or the requirement of due process, since they were based on

an issue not raised by the pleadings nor litigated and were made without affording the petitioners an opportunity to present evidence.

The deficiency notice held that the common stock of the Middle West Utilities Company had not become worthless prior to December 31, 1935. The petitioners claimed the stock was worthless in 1934 or 1935. The issue tried before the Board was therefore whether the common stock became worthless in either of these two years or continued to possess value to the end of 1935. No evidence was offered by the petitioners or the respondent on the question of the worthlessness of the stock prior to 1934 since the Commissioner's deficiency notice had definitely eliminated the necessity for such evidence. The Board found that the common stock was worthless in 1934, but decided against the petitioners on the ground that the stock became worthless in 1932. The decision of the case was thus made without having given petitioners an opportunity to present evidence pertaining to 1932 worthlessness, denied to them a fair trial and was in violation of the spirit underlying the Constitutional requirement of due process of law. (*General Utilities*, 296 U. S. 200, 56 S. C. 185; *Helvering* v. *Wood*, 309 U. S. 344, 60 S. C. 551; and *Hormel* v. *Commissioner*, 61 S. C. 719.)

The determination of the court below that the Board was justified in deciding that the common stock was worthless prior to 1934 even though that issue was not raised by the pleadings was based upon a number of cases where the denial of deductions set forth in the deficiency notices was not on specific and restricted grounds. Those cases are inapposite, for here the Commissioner's denial was upon the specific ground that the common stock of the

Middle West Utilities Company had value at least until December 31, 1935. In the absence of an amendment to the deficiency notice or an affirmative pleading in the answer (neither present here) it became unnecessary for petitioners to prove that the stock had value at the beginning of the taxable year 1934, the first year in which the loss deduction was claimed.

The procedure followed by the Board and the Court below in this proceeding is in direct conflict with the principles announced by this court in *Tex-Penn Oil Co.*, 300 U. S. 481, wherein this court "declined to consider the newly presented question" which "had not been raised by the Commissioner either in his notice of tax deficiency or in his appearance before the Board of Tax Appeals" and in *Hormel* v. *Helvering*, 61 S. C. 719, in which this Court held that litigants must "have the opportunity to offer all the evidence they believe relevant to the issues", and *Clifford* v. *Commissioner*, 309 U. S. 331, which held that "however remote may be petitioners' chances" to establish facts connected with the new issue, nevertheless they should have been afforded an opportunity to present evidence on such issue.

The Circuit Court's holding as to the burden of proof that rests upon petitioners establishes a rule of procedure which affects the public interest, which is unduly onerous and which is contrary to all principles of equity and fairness. "Rules of practice and procedure are devised to promote the ends of justice, not to defeat them." *Hormel* v. *Helvering, supra.*

Argument.

I.

The Board decision and the Circuit Court's affirmance was predicated on an issue not raised by the pleadings or litigated and on which petitioners had had no opportunity to offer evidence and as a result, petitioners were deprived of a fair and full trial.

Firmly imbeded in our system of jurisprudence is the principle that no litigant is to be deprived of the opportunity to offer before a trial body all the evidence he deems relevant to the issues presented, and that such litigant may not be surprised by a decision on an issue upon which he had had no opportunity to introduce evidence. (*General Utilities & Operating Co.* v. *Helvering*, 296 U. S. 200, 206.) This principle has been violated in the instant proceeding and, as a result, petitioners have been denied a fair trial.

Petitioners had deducted in their 1934 return a loss sustained on account of the worthlessness of the common and preferred stock of Middle West. The Commissioner disallowed the deduction, making a determination that the stock had not become worthless prior to December 31, 1935. Petitioners appealed to the Board and in the course of time went to trial. Neither during the intervening period, nor at any time during the course of proceeding did the Commissioner amend his pleading or otherwise move to allege worthlessness prior to 1934. Petitioners proceeded with the trial on the assumption that the stock concededly possessed value up to 1934 and that the only question (in connection with worthlessness) was whether such stock became worthless in 1934 (or in the alternative in 1935) rather than continuing to

possess value to the end of 1935, as determined by the Commissioner. This burden they met and the Board found that the stock was worthless in 1934.

Neither during the course of the trial nor at any time prior to the promulgation of its opinion did the Board indicate that the question of worthlessness prior to 1934 might be in issue or should receive consideration from petitioners. To the surprise of petitioners, the Board, although conceding that petitioners had established the worthlessness of the stock in 1934, nevertheless sustained the disallowance because it found that the stock both common and preferred, had become worthless in 1932. Petitioners' motion to reconsider the question of 1932 worthlessness because that point had not been put in issue, was denied by the Board. An appeal to the Circuit Court followed.

In the appeal to the Circuit Court, petitioners contended that the Board had committed error in thus passing on and deciding an issue which had not been presented or litigated. The Circuit Court refused to reverse, holding that, based on various decisions, the Board was warranted in deciding the issue of 1932 worthlessness although such issue had never been raised.

It may be conceded that the decisions referred to by the Circuit Court, apply in instances where the deficiency determination is predicated either on general grounds, or even on a single but unrestricted ground. Thus in a case of stock worthlessness, if the Commissioner's deficiency notice were to read that no loss had been sustained, concededly and because the determination was on general grounds, the taxpayer would under this rule, be required to establish every element involved in the determination of worthlessness, including cost, existence of value prior to, and cessation of value during, the taxable year. So

also, if the deficiency notice were to merely state that cost had not been established the burden would, under this rule, still be on the taxpayer to establish the existence of value before, and loss of value during, the taxable year in addition to establishing the cost or other basis of the stock. Cf. *U. S.* v. *Factors Finance,* 288 U. S. 289; and *Memphis Cotton Oil,* 288 U. S. 62; for the distinction between general and specific allegations.

It must be self evident however, that the cases relied on by the Circuit Court have no application in those situations where the Commissioner has either conceded one or more of these elements, or has otherwise by his action led the taxpayer to believe that no proof of the existence of such element will be required. Thus, and again taking a case of stock worthlessness, if the deficiency notice were to hold that while cost had been satisfactorily established, worthlessness had not, could it be presumed in the absence of any amendment to the deficiency notice, that that taxpayer must, at the trial of the proceeding, nevertheless offer proof of the cost of the stock in addition to proof or worthlessness!

Petitioners in the instant proceeding are in the last instanced category. Respondent's determination, which was *prima facie* correct and binding on both parties, was "that the stock did not become worthless during or prior to the year 1935". This was not only a determination that the stock was not worthless in 1934, but was equally a determination that the stock possessed value prior to 1934 including the year 1932. (*Taylor* v. *Commissioner,* 70 Fed. (2) 619, 621 affirmed 293 U. S. 507; *Moise* v. *Burnet,* 52 Fed. (2) 1071.) The Commissioner never modified this de-

termination and at the time the trial of this proceeding was had, it was public knowledge that he was before the Board opposing a contention that the stock became worthless in 1932. (*Geo. H. Horning* v. *Commissioner*, 35 B. T. A. 897).

In light of all these circumstances, it can not in fairness and justice be held that the general rule pertaining to a taxpayer's burden of proof required petitioners to submit evidence establishing that Middle West stock possessed value in 1932 and prior to 1934.

II.

The holding that in sustaining a deficiency the Board may consider and decide an issue not presented or litigated, is contrary to the holding of this Court in numerous decided cases.

This court has, in numerous tax cases, had occasion to consider issues raised in the appellate court and not previously presented to the trial body. One of the early cases where such a situation arose was *General Utilities & Holding Co.* v. *Helvering*, 296 U. S. 200. It was there held that Circuit Court of Appeals had erred in considering a contention not previously presented to, or ruled on, by the Board of Tax Appeals. This was followed by *Helvering* v. *Tex-Penn Oil Co.*, 300 U. S. 481, where this court "declined to consider the newly presented question"—which "had not been raised by the Commissioner either in his notice of tax deficiency or in his appearance before the Board of Tax Appeals". To the same effect was the holding in *Helvering* v. *Wood*, 309 U. S. 344 at 349.

Although this court in *Hormel* v. *Helvering*, 61 S. C. 719, seemed to have departed from its earlier holding

of not considering new issues in the appellate court by giving consideration to a new issue raised before it for the first time, this departure was more apparent than real. The court in the *Hormel* case discusses the question at length, pointing out that new issues would be considered only where they constitute questions of law and where a miscarriage of justice might otherwise result. The court was careful to re-affirm its adherence to the principle that litigants must "have the opportunity to offer all the evidence they believe relevant to the issues"—and added that its "recognition of this general principle has caused (the Court) to say on a number of occasions that the reviewing court should pass by, without decision, questions which were not urged before the Board of Tax Appeals". A similar opportunity to submit evidence was given in the case of *O. G. Richter* v. *Helvering,* 61 S. C. 723.

In the *Wood* case the Commissioner had waived reliance on Section 22(a); in the *Tex-Penn Oil Co.* case he had failed to urge a certain issue in the lower court; and in the *General Utilities* case, he had specifically waived the point later urged. Because of these reasons, this Court, in all those cases held that the issues so waived or deliberately not raised below, could not be resorted to thereafter. On the other hand, because reliance on Section 22 (a) was not waived in the *Hormel* case, and the availability of the issue not realized until the promulgation of the *Clifford* decision, consideration of that issue in the appellate court, was in the *Hormel* case, permitted. But even then the case was remitted to the Board in order that the taxpayer might have an opportunity to offer evidence on the new issue "however remote may be his chance to take his case out of the Clifford rule". See also decision of C. C. A., 5th Circuit, pro-

mulgated July 25, 1941, *Dolores Crabb and others* v. *Commissioner.*

In the instant case not only did the ends of justice require that the question of worthlessness in 1932 be not considered, but equitable principles actually barred such consideration. The question as to whether Middle West stock might have become worthless prior to 1934 was specifically excluded by the deficiency determination. It was moreover an issue that could have been raised at any stage of the proceeding. It was in fact actually raised by other taxpayers and strenuously opposed by the Commissioner. To hold, under these circumstances, that the Board may on its own volition consider this issue, render decision on it, and do so without even giving petitioners an opportunity to put in evidence on this point, would be to go contrary to every Supreme Court decision that dealt with the subject of new issues.

III.

The failure to afford petitioners an opportunity to offer proof as to 1932 values, materially and injuriously affected the substantiality of the evidence necessary to sustain the finding of 1932 worthlessness.

In their appeal to the Circuit Court, petitioners also contended that the Board's decision was not supported by substantial evidence. So closely is this point related to the contention that petitioners did not receive a fair trial that it is deemed pertinent to briefly discuss it herein.

The Board found that both the common and preferred stock became worthless in 1932. To buttress its finding of 1932 worthlessness it stated that the record is replete with incidents and occurrences that

establish such worthlessness. It did not however, specify any of them. The Circuit Court could not find any such incidents or occurrences but presumed that the Board had in mind the 1932 receiverships of Middle West subsidiaries. This, however, the Court held did not establish worthlessness. On the contrary it reversed the Board on the holding that the evidence supported a finding of 1932 worthlessness for the preferred stock. In affirming the Board on the worthlessness of the common stock, that court disregarded all evidence other than the report of the receiver submitted in June 1933 which showed no book value for the common stock, resulting from the reserves set up by the accountants. But the fact is, that the reserves in question were set up not only for companies in receivership but also for investments in solvent, going concerns which never went into receivership.

Reserves, particularly those against companies not in receivership, are, after all, merely precautionary ear-markings against possible future losses. Present worthlessness is not to be predicated on the possibility of future losses. The companies are few indeed, that could not at the end of 1932 have set up sufficient reserves to wipe out all book value for the common stock.

The total of subsidiary companies in receivership to the end of 1932 was only $90,000,000 and to the end of 1933 only $100,000,000. Accordingly were it not for the reserves against the companies not in receivership, and assuming that the companies in receivership were a total loss, Middle West's book value would still have been over $200,000,000 leaving a sizeable equity for the common stock.

It is submitted that the question as to whether the Board's finding of 1932 worthlessness was supported

by substantial evidence is at best a very close one. The Board was certainly wrong as regards the preferred stock for there the Circuit Court held with petitioners. And, as stated, even there it was necessary for that court to resort to the accountant's statement (an item not even mentioned by the Board) to sustain the Board's holding as to the common stock. It is therefore not improbable but that had petitioners not been misled as to the absence of any worthlessness issue prior to 1934, they might have been able to establish that the reserves set up by the accountants were to a large extent precautionary, and that throughout 1932 and 1933 a book equity for the common stock actually existed.

Moreover, and even assuming that petitioners would have been unable to establish a 1932 or 1933 book equity for the common stock, they nevertheless might and undoubtedly would have been able to more definitely establish, that throughout this period there was every hope and expectation that something would be salvaged for the common stock, and thus establish value within the tests laid down by numerous cases. *Sterling Morton,* 38 B. T. A. 1270; *A. R. Jones Oil etc.* v. *Commissioner,* 114 Fed. (2) 642 at 646; *John W. Burdan* v. *Commissioner,* 106 Fed. (2) 207.

When it is considered that this court in the *Hormel* and *Richter* cases, held that due process of law required that the taxpayer be permitted to offer evidence before the Board, even though it felt that his chances were remote, how much more reason was it in the present instance, not to have deprived petitioners of their day in court on this question of 1932 worthlessness.

IV.

The Circuit Court's holding that a taxpayer must under all circumstances establish before the Board every essential fact involving in a deduction, is contrary to orderly procedure, imposes an undue burden on taxpayers, and presents a question that affects the public interest.

Aside from the particular question of due process of law involved in the instant proceeding, there is also involved the general question whether in a proceeding before the Board, a taxpayer must, regardless of the wording of the deficiency notice or the action of the Commissioner, prove every element of a deduction. This seems to be the holding of the Second Circuit in the instant case. A different holding was by the same court enunciated in the other cases Cf. *Taylor* v. *Commissioner,* 70 Fed. (2) 619 at 621; and *Moise* v. *Burnet,* 52 Fed. (2) 1071. Other courts hold with the *Taylor* and *Moise* cases. See *Chicago & N. W. Ry. Co.* v. *Commissioner,* 114 Fed. (2) 882 at 889; *Tex-Penn Oil Co.* v. *Commissioner,* 83 Fed. (2) 518, 524. The Board itself, has been inconsistent on this question (Cf. *John J. Seerley,* 43 B. T. A. 50, 57; *Carl M. Britt,* 43 B. T. A. 254 at 260), and may be further confused by the Circuit Court decision in the instant proceeding.

It is believed that the rule governing procedure before the Board as set forth by the Circuit Court in the instant proceeding is, as indicated not only in conflict with and contrary to the holding of other courts, but is in general disregard of the orderly rules of procedure and imposes an undue and improper burden on taxpayers.

In this connection attention may be called to the comments of Mr. Justice Frank of the Second Circuit in the recent case of *Knowlton Moore* v. *U. S.* decided June 24, 1941, as to the inequities of applying an inapplicable rule of procedure to retain a tax illegally collected.

As previously indicated, this court has felt it incumbent upon it to, and has actually passed on, the propriety of considering new issues raised for the first time in an appellate court. It has not apparently ever passed on the specific and important question, whether in the trial body, decision may be had on an issue not submitted to, or litigated before, such trial body, and under what circumstances a decision so predicated may be held to be proper. This question is constantly arising, particularly in proceedings before the Board of Tax Appeals and partakes of a public interest.

Conclusion.

For the above reasons, it is respectfully submitted that the decision below should be reviewed by this court, to the end that petitioners may be afforded an opportunity to present evidence on the issue on which the case was decided, that the rules of procedure be clarified and that justice in the premises be done.

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